Interest Rate Risk

Eliminating interest rate risk is not the goal. However, managing the risk is essential to a sound operation. **When,** NOT IF, interest rates will rise is the question. No one is sure of the answer. However, if you have a strong asset/liability management program and are managing interest rate risk, the 'when' is not important.

Take a few steps now to mitigate your risk:

1) Determine your board of directors' risk tolerance.
Everyone has a certain tolerance for risk. The board of directors needs to identify its tolerance and provide operating management direction for working within these limits. The board's tolerance can often be stated in the amount of net worth the board is willing to lose. Quantifying this level can be done by adopting a minimum capital level after 'shocking' the balance sheet.

2) Analyze your position
Management must determine the current position. Rather than simply grouping all government securities or all real estate loans together, a sound analysis reviews the characteristics of each category. Review maturity, caps, floors, adjustment periods, call dates, and other identifying characteristics of each sub-category of investments and loans.

3) Study the options
Once the current position is reviewed, the balance sheet should be 'shocked' to determine the potential effect of interest rate movement. If the results are not within the board's determined risk tolerance, management should determine a course of action to bring the balance sheet into line with the board's comfort level. Periodic review and continual restructuring of investments or loans will permit a gradual change in assets. This is much preferable to a sudden, more drastic shift that could have detrimental results.

The 10 year treasury note moved upward 146 basis points between June 13 and August 13, 2003. This move in interest rates caused the price of a 5% mortgage backed security to fall from a premium of nearly 103 to a below-par price of 95. Additional increases in interest rates will continue to affect the value of your assets. Be prepared for such changes by appropriately managing your interest rate risk.